United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

Signed

74-2434

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

HICKS NURSERIES, INC.,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court incorrectly held that the taxpayer corporation qualified as a "small business corporation" under Section 1371 of the Internal Revenue Code, when taxpayer had 12 shareholders--two more than the 10 shareholder maximum provided in Section 1371(a)(1) of the Code.

STATEMENT OF THE CASE

This appeal involves tax deficiencies for the years 1964 through 1967 in the amount of $253,334.29 plus interest. The opinion of the Tax Court (Honorable Charles R. Simpson) was entered May 6, 1974, and is reported at 62 T.C. 138

(R. 14.)[1/] The court's decision (R. 31) was entered May 6, 1974. A notice of appeal was filed on behalf of the Commissioner of Internal Revenue on August 2, 1974. (R. 1, 32.) This Court's jurisdiction is based on Section 7482 of the Internal Revenue Code of 1954.

The material facts as stipulated (R. 4-9), and as found by the Tax Court (R. 15-20) may be summarized as follows:

Hicks Nurseries, Inc. (hereinafter referred to as "taxpayer") is a New York corporation, which operates a long-established landscaping and nursery business.[2/] Since its incorporation in 1932, all the stock in Hicks Nurseries, Inc., has been held by members of the Hicks family, persons related to them, and certain employees. (R. 5, 16.) In 1963, the shareholders of Hicks Nurseries decided they wanted to have the corporation taxed as a "small business corporation" as defined in Section 1371(a) of the Internal Revenue Code. Realizing that they had too many shareholders to satisfy the 10 shareholder limitation of Section 1371(a)(1) of the Code, they proceeded to reduce the number of shareholders. Certain shareholders had their stock redeemed, leaving 12 shareholders, including Mr. and Mrs. Hicks and Mr. and Mrs. Emory, each of whom owned stock in their separate individual capacities. (R. 16.) Apparently at the advice of the

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1/ "R." references are to the separately bound record appendix. "Tr." references are to the transcript of proceedings before the Tax Court.

2/ The Hicks Nurseries business has operated since 1853, and was incorporated in 1932. (R. 5.)

the corporation's accountant (Tr. 4-5), and in attempt to reduce the number of shareholders from 12 to 10, each husband and wife (Mr. and Mrs. Hicks and Mr. and Mrs. Emory) transferred one of their separate shares into joint tenancy with the other spouse. This occurred on December 31, 1963. (R. 5, 16-17.) As of January 1, 1964, Hicks Nurseries stock was held as follows:

Edwin Hicks	412
Eloise L. Hicks	42
Mr. and Mrs. Hicks, jointly	2
Alfred H. Hicks	49
Susan L. Hicks	20
Ralph Hicks	25
John M. G. Emory	16
Esther H. Emory	46
Mr. and Mrs. Emory, jointly	2
Margaret W. Emory	12
Edwin H. Costich	31
Peter E. Costich	25
Robert J. Patterson	12
Earl M. Good	17
TOTAL	711

(R. 5.)

On January 30, 1964, Hicks Nurseries filed an election to be taxed as a small business corporation. (R. 10, 17.) For the years 1964 through 1967, the tax years in issue, it filed returns as a "small business corporation." (R. 20.) On December 19, 1969, following an audit of the taxpayer-corporation's returns, the Commissioner of Internal Revenue issued a notice of deficiency in which he determined that the taxpayer corporation did not qualify to be taxed as a small business corporation due to the 10-shareholder limitation, and proposed the assessment of the regular corporate income taxes imposed by Section 11 of

the Code. (R. 20.)[3/]

Taxpayer relied on Section 1371(c) of the Code, and the regulation implementing that provision, which permit stock held by a husband and wife jointly to be treated as owned by one shareholder. Taxpayer argued that since Mr. and Mrs. Hicks (each of whom owned stock in his or her individual capacity) also owned two shares of stock as joint tenants, they should be counted as one shareholder and not two. (The same argument applied to the Emorys.)

The Commissioner argued that, notwithstanding the two shares they held as joint tenants, Mr. and Mrs. Hicks also held 412 shares and 42 shares, respectively, in their separate individual capacities, and that they (as well as the Emorys) should accordingly be counted as separate shareholders. The fact that they also held two shares as joint tenants did not, in the Commissioner's view, reduce by two the number of shareholders which should be counted by virtue of their separate holdings.

3/ Subsequent to 1964, Mr. Emory died and his shares passed to his estate, which then became a shareholder for purposes of Section 1371(a)(1). (R. 18.) Although the estate was required to file a consent to have the corporation taxed as a small business corporation, a timely consent was not filed. The Commissioner originally granted an extension of time to file this consent, but later withdrew the extension. In the court below, taxpayer challenged the withdrawal of the extension. (R. 20.) This issue was decided in taxpayer's favor (R. 29, 30), and we are not challenging this holding on this appeal.

The court below held in taxpayer's favor, based on the finding that taxpayer's interpretation of the regulation involved was not an unreasonable one. The court did not consider whether the result reached under taxpayer's interpretation was consistent with or authorized by the statute. Nor did the court consider whether the Commissioner's interpretation was a correct application of the statutory requirements. From this decision, the Commissioner appeals.

SUMMARY OF ARGUMENT

This case involves the 10-shareholder limitation of Section 1371(a) of the Internal Revenue Code of 1954, which sets forth the requirements for eligibility to be taxed as a "small business corporation." Section 1371(a)(1) provides that an organization cannot qualify for treatment as a small business corporation if it has more than 10 shareholders.

The facts in this case are not disputed. Taxpayer-corporation, Hicks Nurseries, at all relevant times has had 12 shareholders, each of whom owned stock in his or her individual capacity. Four of these shareholders, Mr. and Mrs. Hicks and Mr. and Mrs. Emory, also held, in addition to their respective individual holdings, two shares each as joint tenants, each with his or her spouse. The Code is clear as to such stock ownership; under Section 1371(a)(1), all persons owning stock separately or jointly with another are treated as separate shareholders. Section 1371(c), added to the Code in 1959, provides a limited exception to this general rule. Under Section 1371(c), stock which is held by a husband and wife as joint tenants is treated as held by one shareholder. Section 1371(c), however, did not change the rule for counting shareholders with respect to individually, separately, owned shares. The Treasury Regulations issued under Section 1371(a) and (c) implement these rules.

In this case, there were 12 shareholders for purpose of Section 1371(a), since there were 12 persons each of whom owned Hicks Nurseries stock in his or her individual capacity (and not as a joint tenant). Accordingly, Hicks Nurseries exceeded by two the 10-shareholder maximum. The fact that two sets of married shareholders (the Hicks' and Emory's) also held jointly owned shares did not under the statute or implementing regulation reduce the number of shareholders from 12 to 10. The contrary result reached below is incorrect as a matter of law.

The court below did not consider whether the result it reached was consistent with the statutory requirements, or whether the Commissioner's interpretation of the implementing regulation was correct. The court ruled in taxpayer's favor apparently on the grounds that taxpayer had made what the court believed was a good-faith attempt to satisfy the 10-shareholder limitation, and that in so doing taxpayer had relied on what the court saw as a reasonable interpretation of the Regulations. But the legal result of this approach is to permit a rule antithetical to that of the statute to be reached based on a taxpayer's erroneous interpretation of a regulation.

Further, the heart of taxpayer's argument below was that the regulation was unclear as to its meaning, and that the interpretation given the regulation by taxpayer's advisor was a reasonable one. We submit that when the regulation is read in

its entirety, rather than when portions of the regulation are taken out of context, and when the regulation is considered in light of its obvious, overall purpose, its provisions are clear and unambiguous. The rule articulated in the regulation, and which governs in this case, is that persons owning stock individually are counted separately; the addition of joint shares does not affect the manner in which the individual holdings are counted.

Accordingly, under the Code and implementing Regulations, Hicks Nurseries had 12 not 10 shareholders and therefore was not eligible for treatment as a small business corporation. The decision of the Tax Court to the contrary should be reversed.

ARGUMENT

THE TAX COURT INCORRECTLY DETERMINED THAT THE TAXPAYER CORPORATION SATISFIED THE 10-SHAREHOLDER LIMITATION OF SECTION 1371(a) AND THEREBY QUALIFIED FOR TREATMENT AS A "SMALL BUSINESS CORPORATION"

A. Introduction

Sections 1371 through 1378 (Subchapter S of the Internal Revenue Code) provide special rules for the tax treatment of organizations which qualify as "small business corporations" as defined in Section 1371(a) of the Internal Revenue Code of 1954, Appendix, infra.[4/] A qualified small business corporation (frequently referred to as a "Subchapter S corporation") does not pay the tax normally imposed at the corporate level, and instead the income of the corporation is taxed directly to the shareholders in proportion to their holdings. The purpose of these provisions, generally, is to allow taxpayers to choose, in limited circumstances, a simplified form of organization, without taking into account the major tax consequences of their selection (see Fulk & Needham, Inc. v. United States, 411 F. 2d 1403 (C.A. 4, 1969).

In order to qualify as a small business corporation under Section 1371(a), the corporation must not have more than 10

4/ The provision of Section 1371 was added to the Code in 1958 by the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606; the provision of Section 1378 was added to the Code in 1966 by Sec. 2(a), Act of April 14, 1966, P.L. 89-389, 80 Stat. 111.

shareholders.[5/] Section 1371(a) provides, in pertinent part, as follows:

> (a) Small Business Corporation--For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in Section 1504) and which does not--
>
> (1) have more than 10 shareholders;
>
> * * *

Section 1371 was amended by Act of September 23, 1959, P.L. 86-376, 73 Stat. 699, adding Section 1371(c), Internal Revenue Code of 1954 (Appendix, infra) which, with respect to the 10-shareholder limitation, provides in pertinent part as follows:

> (c) Stock Owned by a Husband and Wife--For purposes of subsection (a) (1) stock which--
>
> * * *
>
> (2) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common, shall be treated as owned by one shareholder.

This case involves the application of the Regulations, promulgated under Section 1371, which provide rules for determining the number of shareholders for purposes of the 10-shareholder limitation of Section 1371(a). Specifically, the regulation

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5/ Other conditions of Subchapter S status include the requirements that there be only one class of stock, and that each shareholder be either an individual or an estate. See, generally, 7 Mertens, Law of Federal Income Taxation (Rev.), § 41B.02. See, also, Sec. 1371(a) of the Internal Revenue Code of 1954.

(§ 1.1371-1(d)(2) of the Treasury Regulations on Income Tax (1954 Code) Appendix, infra) (which is entitled "Stock owned by husband and wife") considers the number of shareholders which should be counted when a husband and wife hold stock in their joint names (in addition to stock, if any, held separately by one or both of them).

The Tax Court below incorrectly applied this regulation to the undisputed facts in this case, and in permitting Hick Nurseries to qualify as a small business corporation, the court reached a result which is contrary to the statute. Section 1371(a) provides that Subchapter S status shall not be allowed when the corporation has more than 10 shareholders, and it is undisputed in this case that all relevant times Hicks Nurseries had 12 separate shareholders. The fact that Mr. and Mrs. Hicks (and Mr. and Mrs. Emory) each held two shares of stock as joint tenants in addition to their separate holdings did not reduce the number of shareholders from 12 to 10.

B. There is no basis in the statute for treating taxpayer's 12 separate shareholders as 10 shareholders for purpose of Section 1371(a)(1)

In permitting Hicks Nurseries to treat its 12 separate stockholders as 10 shareholders for purpose of the 10-shareholder limitation of Section 1371(a)(1), the court below was incorrect as a matter of law. This result was reached solely by virtue of the fact that two sets of married shareholders

each held, in addition to their respective separate holdings,[6/] two shares of stock as joint tenants. As will be shown, the fact that the parties held jointly owned stock in addition to their separate, individually owned shares, does not, as a matter of law, change or otherwise affect the manner in which the separately owned stock should be counted. Thus, by virtue of the 12 persons who owned Hicks Nurseries stock in their separate, individual capacities, Hicks Nurseries had 12 and not 10 shareholders for purposes of Section 1371(a), and by the terms of the statute, Hicks Nurseries did not qualify for treatment as a small business corporation.

The legal error of the trial court is clear and is based on the well-recognized (and undisputed) general rules for determining the number of shareholders under Section 1371(a), and the limited impact on these rules caused by the addition of Section 1371(c) to the Code in 1959.

Absent the application of Section 1371(c), the rule to be applied in computing the number of shareholders for purposes of the 10-shareholder limitation is to determine the persons who would have to include in gross income the dividends distributed

6/ Mr. Hicks owned 412 shares in his name, and Mrs. Hicks owned 42 shares in her name. Similarly, Mr. Emory held 16 shares in his name and Mrs. Emory held 46 shares in her name. (R. 5.)

with respect to the stock. Treasury Regulations on Income Tax (1954 Code), Section 1.1371-1(d)(1), Appendix, infra. Under the regulation, any person, such as a person owning stock in his name, as a joint tenant or as a tenant in common, would be counted as a shareholder. (In addition, applying a beneficial interest test of ownership, a person for whom stock is held by another as nominee, agent, or guarantor is considered a shareholder.) Thus, as a general matter (again absent application of Section 1371(c)), each person who owns stock in his or her own name or jointly with another is counted as a separate shareholder. Neither the taxpayer nor the Tax Court disputed this general rule. Indeed, the Tax Court recognized the principle that all separate shareholders (including husbands and wives) are counted separately when it noted (R. 23) that taxpayer's 12 shareholders (before the creation of joint tenancy with respect to four shares of stock) caused taxpayer to exceed the 10 shareholder limit of Section 1371(a)(1).

When Section 1371(c) was added to the Code in 1959, it changed the rule only for counting the number of shareholders with respect to stock owned jointly by a husband and wife. See Sec. 1371(c) of the Code. The limited effect of Section 1371(c)(2) on the rules for counting the number of shareholders is plainly demonstrated by the terms of the statute itself

which states " * * * stock which * * * is held by a husband and wife as joint tenants * * * shall be treated as owned by one shareholder."[7/] The limited intent of Congress in adding Section 1371(c) is evidenced in the Senate Committee Report issued when Section 1371(c) was originally proposed as an addition to the Code in 1959. The Senate Report (S. Rep. No. 913, 86th Cong., 1st Sess., pp. 1-2, 1959-2 Cum. Bull. 903) states:

> Section 2 of the bill, added by your committee, relates to the election of certain small business corporations as to their taxable status.
>
> Subsection (a) of section 2 makes it clear that, in determining the number of shareholders of a small business corporation, a husband and wife owning stock jointly or as community property shall be counted as only one shareholder. This amendment would apply to taxable years beginning after December 31, 1959. Under existing law a small business corporation may not have more than 10 shareholders. It is clear from the manner in which the word "shareholder" is used in connection with small business corporations that each person having a community or common interest in stock must be counted as a shareholder.

The clearly evidenced intent of Congress was to change the rules with respect to jointly held stock only. No mention is made

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7/ The statute does not provide, as taxpayer would contend, that a husband and wife who own stock jointly shall be treated as one shareholder no matter what other separate holdings they may have. The statute only states how the jointly held stock should be counted; its silence on how the other separate stock is treated is understandable, for such stock should logically still be treated as separate, and this is indeed the position of the regulations.

of separately owned stock and, it follows, persons who own stock separately continue to be counted as separate shareholders--even though they may be husband and wife. Thus, the established rules under Section 1371 require that the 12 persons who own stock in Hicks Nurseries in their respective individual names, separately and not as joint tenants, be counted as 12 shareholders for purposes of Section 1371(a).

The Tax Court below apparently did not consider whether the result it reached was in conflict with the statute, but permitted taxpayer to prevail on the theory that the taxpayer's construction of the regulation was reasonable, and that to hold against the taxpayer would cause taxpayer irreparable detriment. (R. 25.) This approach, as we will show, was both legally and logically incorrect.

C. The Tax Court below relied on an incorrect and unreasonable interpretation of the regulation

In holding in taxpayer's favor, the Tax Court permitted taxpayer to treat Mr. and Mrs. Hicks as one shareholder (and Mr. and Mrs. Emory as one shareholder), solely by virtue of the two shares of stock held jointly by each of these couples, and notwithstanding the fact that each of these individuals held significant amounts of Hicks Nurseries stock separately in his or her own name. This result is based exclusively on taxpayer's incorrect interpretation of Section 1.1371-1(d)(2) of the Treasury Regulations on Income Tax (1954 Code),[8/] which provides guidance

8/ This provision of the Regulations was initially promulgated in T.D. 6432, 1960-1 Cum. Bull. 317, 319, filed December 19, 1959.

for the application of Section 1371(c) of the Code dealing with stock held jointly by a husband and wife.

Although the statute is explicit insofar as it provides that jointly held stock (by a husband and wife) is treated as held by one shareholder, the statutory provisions do not explain how the "one shareholder" rule for jointly held stock should be applied when the parties, in addition to jointly owned stock, also hold stock in their own separate names. Any uncertainty as to how the jointly owned and the separately owned stock is counted as resolved in the regulation, which in three sentences prescribes the number of shareholders to be counted in all circumstances when a husband and wife hold jointly owned stock. The regulation, in pertinent part, provides:

> (2) Stock owned by husband and wife. (i) Except as otherwise provided in this paragraph, in determining whether a corporation meets the 10-or-fewer-shareholders requirements of section 1371(a)(1), stock which--
>
> * * *
>
> (b). Is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common, shall be treated as owned by one shareholder. For this purpose, if a husband or wife owns stock in a corporation individually, and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder. However, if the husband and wife each owns stock in the corporation individually, they will be treated as two shareholders.
>
> * * *

In substance, the regulation provides, in the first sentence, that if the parties hold only jointly owned stock, they are counted as one shareholder. (This result is mandated by the clear and unambiguous language of Section 1371(c).) The second sentence provides that if the husband or the wife (but not both) own stock separately in his or her own name, in addition to jointly owned stock, one shareholder should be counted. Finally, in the third sentence the regulation provides that if, in addition to jointly held stock, both the husband and the wife own stock separately, two shareholders should be counted.

The error of the court below was in permitting taxpayer to look only to the second sentence of the regulation, and to count Mr. and Mrs. Hicks as one shareholder (and Mr. and Mrs. Emory as one shareholder) when, instead, the court should have applied the third sentence of the regulation and counted each person (Mr. and Mrs. Hicks and Mr. and Mrs. Emory), for a total of four shareholders.

It is clear, under the third sentence of the regulation,[9/] that Hicks Nurseries had 12 shareholders and that, therefore, it could not qualify for Subchapter S treatment due to the 10-shareholder limitation. The regulation requires that, since each

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9/ This third sentence of the regulation provides:

> However, if the husband and wife each owns stock in the corporation individually, they will be treated as two shareholders.

spouse also owns stock separately, such separate, individual holdings of Mr. and Mrs. Hicks (as well as Mr. and Mrs Emory) be counted separately.

The court below noted (R. 23-24) that the third sentence of the regulation does not expressly state its application to situations involving jointly owned stock. Literally speaking, this is true, but this sentence is contained in a regulation which was clearly intended to give guidance in counting the number of shareholders when jointly held stock is involved. There are three possibilities dealt with: (1) all stock is owned jointly; (2) stock is owned jointly and either husband or wife (but not both) owns stock separately, and (3) stock is owned jointly and both husband and wife own stock separately. In three sentences the regulation deals with the three possible situations in sequence. If, as it clearly appears, the regulation was intended to consider these three possibilities involving stock owned jointly, then the third sentence of the regulation, upon which the Commissioner relies, governs the situation here, and requires the counting of Mr. and Mrs. Hicks (as well as Mr. and Mrs. Emory) as two shareholders.

Additional support for the Commissioner's position that the third sentence of the regulation applies when there is jointly held stock, is found in the title of the regulation, and its introductory sentence. The regulation is entitled "Stock owned by husband and wife"--the same title given Section 1371(c) of the Code, which deals <u>only</u> with the manner in which jointly held

stock should be counted. Also, the introductory sentence of the regulation provides, in part, as follows:

> Except as otherwise provided in this paragraph * * * stock which * * * is held by a husband and wife as joint tenants * * * shall be treated as owned by one shareholder. * * *

The reference in this sentence to jointly held stock and the phrase "except as otherwise provided" clearly shows that the entire paragraph (in which the third sentence at issue is located) was intended to deal with situations involving jointly held stock.

Taxpayer argued below that the second and not the third sentence of the regulation applies when both the husband and the wife own stock individually, and also own stock jointly. We submit taxpayer's interpretation of the regulation is unreasonable and, since it leads to a result which is contrary to law, taxpayer's interpretation should not have been permitted to govern the result in this case. As the court held in United States v. Massey Motors, 264 F. 2d 552 (C.A. 5, 1959), aff'd, 364 U.S. 92 (1960), a taxpayer should not be permitted to rely on a construction of a regulation which would lead to a result not authorized by statute, since, if the regulation were given such a construction, the court would have to declare invalid the regulation upon which taxpayer relies. United States v. Massey Motors, supra, p. 558.

Aside from being contrary to law, taxpayer's interpretation of the regulation at issue clearly does not otherwise represent a reasonable construction of the regulation's provisions. Taxpayer and the court below (R. 23) relied on the second sentence of the regulation which provides as follows:

> For this purpose, if a husband or wife owns stock in a corporation individually, and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder.

Under this provision of the regulation, if either the husband or the wife, but not both, owns stock separately in addition to jointly owned stock, one shareholder is counted. The sentence of the regulation is inapplicable here, however, because both Mr. and Mrs. Hicks (and both Mr. and Mrs. Emory) continued to own Hicks Nurseries stock separately, in their individual capacities.

Taxpayer argued below (R. 23) that the word "or" in the second sentence of the regulation should be read as "and/or" relying on Section 1.368-2(h) of the Treasury Regulations on Income Tax (1954 Code, Appendix, infra.[10/] The cited regulation

10/ In fact, this Section 1.368-2(h) regulation only purports to provide a rule of construction for purposes of "Section 368 as well as other provisions of the Internal Revenue Code", and does not on its face offer a rule for construing Regulations. In any event, a regulation should be read in its entirety, and should be given a meaning consistent with the statute and the purposes for which th statute was enacted. See United States v. Massey Motors, supra.

permits "or" to be read as "and/or" only "if the context so requires"--a limitation not referred to by the court below in its opinion.

The context of the regulation does not require the reading of "or" as "and/or." To the contrary, the context of the regulation as well as the provisions of the statute prohibit it. Of course, a simple answer to taxpayer's contention is that the regulation says "or" and not "and." In addition, and as previously noted in our analysis of the regulation's third sentence, the regulation must be read in its entirety, and a meaning should be given to its provisions which is consistent with the purposes for which the regulation was issued. The regulation was obviously intended to give guidance in counting the number of shareholders in the three possible situations involving jointly held stock, and the only way the regulation achieves this purpose is to construe "or" as "or." If so construed the regulation as a whole deals in a logical fashion with the three possible situations.

A further reason for not adopting taxpayer's reading of the regulation is that such interpretation is in conflict with the clearly intended meaning of the regulation's third sentence which, as we have shown, governs the situation, such as here, where a husband and wife both own stock individually. To resolve this conflict, taxpayer offers a strained construction of the regulation's third sentence which, in effect, taxpayer reads by inserting the following underlined language:

> However, if the husband and the wife each owns stock in the corporation individually (and they do not own stock jointly) they will be treated as two shareholders.

This interpretation of the regulation is unreasonable since, if the third sentence means what taxpayer contends, the sentence of regulation would be entirely extraneous. This section of the regulation (1.1371-(d)(2)) is entitled "Stock owned by husband and wife." It is obvious, from the regulation's caption and its provisions, that the regulation was intended to clarify the operation of the provisions of Section 1371(c), which is also captioned "Stock owned by husband and wife," and which deals with the number of shareholders which should be counted when a husband and wife own stock jointly. Yet, taxpayer contends that the third sentence of the regulation should be read so as not to involve jointly held stock. If the third sentence is so read, it would be irrelevant and not pertinent to the regulation in which it is found. Such a strained reading of the regulation cannot be permitted in light of the regulation's clear overall purposes.

In conclusion, the interpretation of Section 1.1371-1(d)(2) of the Regulations relied on by the court below is unreasonable. When the regulation is read in its entirety, and with a view to the statute it implements, it is clear that the third sentence and not the second sentence governs this case. The only way taxpayer has been able to seek refuge in this regulation has been to take the second sentence out of context, and to give to

the sentence a clearly unintended meaning, which reaches a result which is not authorized by law.

D. Section 1.1371-1(d)(2) of the Regulations, as construed by the Commissioner, represents a correct interpretation of the statute and is, therefore, valid

The Tax Court did not directly consider whether the Commissioner's interpretation of the regulation was correct, or whether the regulation, if so construed, represented a valid exercise by the Secretary of the Treasury of his authority to issue Regulations. (R. 25-26.) The court did note, however, that it saw no reason for treating differently the situation where (in addition to joint shares) either the husband or wife, but not both, own shares individually, and the situation where both own separate shares in addition to the joint shares. The regulation as construed by the Commissioner does treat these situations differently, and the distinction is a reasonable application of the statute.

As a general matter, the Secretary of the Treasury has broad authority to establish Treasury Regulations (Section 7805(a) of the Internal Revenue Code of 1954, Appendix, infra), and the courts have uniformly stated that such Regulations must be sustained unless they are unreasonable and plainly inconsistent with the revenue statute. United States v. Correll, 389 U.S. 299 (1967); Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948). Section 1.1371-1(d)(2) of the Regulations, as construed by the Commissioner, is both reasonable and

consistent with the statute. As we have shown, as a general rule under Section 1371(a)(1), all persons who own stock (or have a beneficial interest in stock) in their individual capacities or jointly with another are counted as separate stockholders. Section 1371(c) provides a limited exception to the manner in which jointly held stock should be counted. Stock which is held jointly by a husband and wife is treated as owned by one shareholder. The regulation merely implements these basic rules. When there is only jointly held stock, one shareholder is counted--as Section 1371(c) plainly requires. When either the husband or wife, but not both, owns stock individually in addition to their jointly held stock, the regulation requires that only one shareholder be counted. The regulation, in effect, treats the "one shareholder" resulting from the jointly held stock as being the same as the spouse owning stock individually.

Finally, in the situation, as here, where both husband and wife hold (in addition to joint shares) shares in their separate individual names, the regulation requires that two shareholders be counted. At least two shareholders, and not one as contended by taxpayer, must be counted since there are two individuals (the husband and wife) each of whom owns stock in his or her separate individual capacity. The undisputed general rule under Section 1371(a) requires that all persons who hold stock individually--including husbands and wives--are counted as separate shareholders under Section 1371(a)(1). Section 1371(c) did not change this rule, but only changed the rule for counting the

number of shareholders resulting from jointly owned stock. Clearly, under the statute no less than two shareholders can be counted in this situation, and the regulation properly implements this rule of law.

One final matter warrants mention. Contrary to the Tax Court's view (R. 24-25), this is not a situation in which the Commissioner has adopted a new, more restrictive interpretation of a regulation and attempted to apply the new position retroactively to the detriment of the taxpayer. The regulation at issue was originally adopted in 1959, shortly after the provisions of Section 1371(c) were added to the Code. This being a case of first impression, and there being no known prior publication or administrative announcement of a position of the Internal Revenue Service to the contrary with respect to this issue, the Commissioner's view is not clouded by any inconsistency or shift in position. Moreover, this is not a case of "restrictive interpretation" as suggested by the trial court; the Commissioner is simply seeking the enforcement of the 10-shareholder limitation contained in the statute.

CONCLUSION

For the above-stated reasons, the decision of the Tax Court is incorrect and should be reversed.

Respectfully submitted,

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DECEMBER, 1974.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 12th day of December, 1974, in an envelope, with postage prepaid, properly addressed to them as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.)

SEC. 1371 [as added by Sec. 64(a), Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606]. DEFINITIONS.

(a) Small Busines Corporation.--For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not--

(1) have more than 10 shareholders;

(2) have as a shareholder a person (other than an estate) who is not an individual;

(3) have a nonresident alien as a shareholder; and

(4) have more than one class of stock.

* * *

(c) [as added by Sec. 2(a), Act of September 23, 1959, P.L. 86-376, 73 Stat. 699] Stock Owned by Husband and Wife.--For purposes of subsection (a)(1) stock which--

(1) is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State, or

(2) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder.

* * *

SEC. 7805. RULES AND REGULATIONS.

(a) Authorization.--Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.1371-1 Definition of small business corporation.

* * *

(d) Number of shareholders--(1) In General. A corporation does not qualify as a small business corporation if it has more than 10 shareholders. Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be the shareholders of the corporation. For example, if stock is owned by tenants in common, joint tenants, or tenants by the entirety, each tenant in common, joint tenant, or tenant by the entirety is generally considered a shareholder, but see subparagraph (2) of this paragraph relating to stock owned by husband and wife. Persons for whom a stock in a corporation is held by a nominee, agent, guardian or custodian will generally be considered shareholders of the corporation. If stock is owned by a trust which is subject to the provisions of subchapters D, F, H, or J, chapter 1 of the Code, or by a voting trust, the trust is considered the shareholder even though the dividends paid to the trust are includible directly in the income of the grantor or some other person. If stock is owned by a partnership, such partnership and not its partners is considered to be the shareholder.

(2) Stock owned by husband and wife. (i) Except as otherwise provided in this paragraph, in determining whether a corporation meets the 10-or-fewer-shareholders requirement of section 1371 (a)(1), stock which--

(a) Is community property of a husband and wife (or the income from which is community income) under the applicable community-property law of a State, or

(b) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder. For this purpose, if a husband or wife owns stock in a corporation individually, and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder. However, if the husband and wife each owns stock in the corporation individually, they will be treated as

two shareholders. This subdivision applies only in determining the number of shareholders for purposes of section 1371(a)(1) and does not apply for purposes of any other provision of subchapter S, chapter 1 of the Code. Thus, for example, the husband and wife will each be considered a shareholder for purposes of section 1372(a), relating to the requirement that all shareholders consent to the corporation's election, and section 1373(a), relating to the inclusion in the shareholder's gross income of the corporation's undistributed taxable income.

(ii) For taxable years of a corporation which begin before January 1, 1960, the provisions of subdivision (i) of this subparagraph shall not apply in determining the number of shareholders unless the circumstances and requirements set forth in subparagraph (3) of this paragraph are satisfied. Thus, if stock is owned as community property (or if the income from the stock is community income), or if stock is owned by a husband and wife as tenants in common, joint tenants, or tenants by the entirety, then (unless the circumstances and requirements of subparagraph (3) of this paragraph are satisfied) for any taxable year of the corporation which begins before January 1, 1960, both the husband and wife having a community interest in such stock (or the income therefrom) and each tenant in common, joint tenant, or tenant by the entirety is generally considered a shareholder.

* * *

§1.368-2 Definition of terms.

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(h) As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction "or" denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if "stock and securities" are received in exchange as well as if "stock or securities" are received.